Banking Union: what way out of the current deadlock?

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In response to the EU sovereign debt crisis (2011-2012), the European Union launched the Banking Union project to safeguard financial stability, deliver a safer banking sector, reduce the sovereign-bank nexus and protect taxpayers from the cost of bank failures. The Banking Union, currently covering 21 Eurozone countries, is also open to other EU Member States.

The Single Supervisory Mechanism (SSM, created in 2014) has helped promote a resilient banking sector, but the banking market remains too fragmented and over-banked in Europe, and market concentration has only progressed at domestic level. The SSM and the Single Resolution Mechanism (SRM, created in 2014) has failed to provide the expected degree of cross-border banking integration in the EU: in particular, transnational banking groups are unable to manage their capital, liquidity and MREL liabilities on a consolidated basis, and the market for retail banking services has not progressed.

European banking markets remain fragmented, and the home-host dilemma has not been resolved. As a result, the Banking Union project has remained in a deadlock for years.

This paper aims at proposing ways forward to get out of the political deadlock and progress in the completion of the Banking Union, which is defined in this paper as the combination of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS).

The first part of this paper describes the benefits that a genuine Banking Union would bring about in terms of competitiveness for the EU banking sector. The second part focuses on the existing loopholes in the design of the Banking Union that make it fragmented and suboptimal. The third part assesses the ways forward that have been identified but that have been hampered by the prevalence of national interests over European ones. Eventually, the fourth part explores potential ways out of the deadlock and guidelines to resume making meaningful progress on the Banking Union.

1. A genuine Banking Union would be beneficial for the competitiveness of the EU banking sector

A genuine Banking Union would offer several benefits to the EU banking sector, and *a fortiori* to the EU financial sector as a whole. The first section shows that completing the Banking Union would foster the integration of banking markets and consequently make the allocation of resources across the EU economy more efficient. The second section focuses on the synergies existing between the Banking Union and the Capital Markets Union: advancing on both these projects would reinforce the EU financial sector. The third section however explains that one should not overestimate the benefits the EU would reap from having a genuine Banking Union.

1.1 A genuine Banking Union would accelerate the integration of banking markets, which is a prerequisite for a more effective allocation of resources across the EU economy

A genuine Banking Union would promote a better integration of EU banking markets – *i.e.* banking markets where banks operate within the Euro area as they would in their home jurisdiction – which in turn would foster a more effective allocation of resources across the Eurozone (*e.g.*, companies would be able to tap wider and cheaper sources of bank funding) in addition to achieving a better diversification of risks. In such a context, transnational banking groups of the Euro area would be considered as unique entities from an operational, regulatory and supervisory perspective, and not as a sum of separate subsidiaries ("the solo approach"). In other words, the EU legislative framework would recognize transnational banking groups at the consolidated level.

Therefore, an effective Banking Union would improve the development of transnational and competitive banking groups in the EU which would help Eurozone's excess savings to circulate across borders to parts of Europe where most attractive investment opportunities exist: any company in any Member States could finance its investment projects through any subsidiary or branch located anywhere in the Banking Union.

Resilient transnational banking groups would also enhance private risk sharing mechanisms: if there are transnational banks that operate in various parts of the Union, they can offset any losses made in the recession-hit region with gains in another one and can continue to provide credit to sound borrowers. Depositors would also contribute to the financing of a more diversified pool of assets which would insure them against shocks specific to their home country.

Furthermore, the Banking Union is a crucial step towards a genuine Economic and Monetary Union as it allows for the consistent application of EU banking rules in the participating countries, leading to a resilient banking sector. Moreover, it improves the efficiency of the transmission of the monetary policy, for which banking activities play an essential role in the Euro area.

1.2 Apparent synergies exist between the Banking Union and Capital Markets Union

Having a fully-fledged Banking Union would also contribute to the development of the Capital Markets Union (CMU) which would benefits investment and competitiveness of the EU.
Indeed, Banking Union and Capital Markets Union are "mutually reinforcing initiatives that can bring the Single Market for financial services to the next level[1]" as banks and capital markets complement each other in financing the real economy. More precisely, V. Constâncio explains that "a more resilient banking system supports the smooth functioning of capital markets. For example, resilient banks are more likely to act as market makers for certain capital markets instruments and may ideally buffer extreme price movements in times of crisis. Furthermore, well-capitalized banks are less likely to be forced to fire sale certain asset classes. This leads to less market disruptions in time of crisis".

Reciprocally, capital markets union supports Banking Union: more integrated and jointly regulated capital markets would support cross-border activities and resilience of banks. V. Constâncio highlights that "in a significantly more integrated capital market, banks would no longer need to develop local expertise for each national capital market. They could exploit cross-border economies of scale more easily by offering similar or even the same products and services in another Member State. By operating in a larger, integrated market, banks would likely increase the cross-border holdings of assets and be able to build larger and more diversified collateral pools for securitized products and covered bonds".

Eventually, the Banking Union, together with the CMU may play a significant role in enhancing the open strategic autonomy of the EU and strengthening confidence in the euro. Strategic autonomy requires, among other things, converging EU economies, a strong and widely used currency, and a resilient, competitive and thriving financial sector. These, in turn, would greatly benefit from *e.g.* a Eurozone safe asset, deep capital markets and a single banking market.

1.3 Nonetheless, the benefits of the Banking Union should not be overestimated

Progress on the Banking Union requires above all economic convergence between the largest Member States (Germany, France, Italy, Spain) to restore trust amongst European leaders, without which cooperation is not possible. Economic convergence and sound public finances in all parts of the EU are essential to restore trust among Member States, break the sovereign-bank doom loop[2], foster the creation of a EU safe asset and reach a European agreement on European Deposit Insurance Scheme (EDIS).

Moreover, progress on the Banking Union and the CMU has been hampered by an adverse monetary and economic environment for more than a decade: interest rates are systematically lower in Europe compared to the US, leading Member States with excess savings such as Germany and the Netherlands to invest in the US instead of countries with low GDP per capita such as Spain, Italy, Portugal and Greece as it is better remunerated in the US, and economic growth is higher in the US than in the EU, especially because of the economic heterogeneities between the main Member States and the lack of common policy regarding industry, energy, defense, etc.

Cross country differences in approaches regarding state aid and bank taxes are other hurdles to progress in the Banking Union. While state aid creates obstacles for competition across the EU because they are asymmetrically granted by Member States, bank tax proposals in one country spread turbulence across the EU as was seen in the case of EU banks' stock prices and the Italian bank tax proposal[3].

1. V. Constâncio, "Synergies between Banking Union and capital markets union", keynote speech at the joint conference of the European Commission and the European Central Bank on European Financial Integration, 19 May 2017.
2. Except if we had EDIS and if banks had diversified sovereign bond portfolios and diversified lending portfolios, which is not the case at the time this note is written.
3. "On August 7, 2023, Italy's vice-president M. Salvini unexpectedly announced a 40% tax on bank windfall profits (...) The markets responded spectacularly, send Italian bank shares plummeting on the Milan Stock Exchange." Source: "Italy announces tax on bank windfall profits, causing stock to plummet", Le Monde, 9 August 2023.

Beyond this adverse economic environment, the development of the CMU requires adjustments that are not linked to progress in the Banking Union:

- Similar interest rates on the euro and the US dollar in order to avoid capital outflows,
- Long-term saving products[4] (*e.g.* pension funds),
- Stimulation of household investment in equity-like products (taking into account EU retail savers' aversion to risk); this links with the EU Retail Investment Strategy,
- An effective EU market for securitization,
- Rules that do not disincentivize equity financing (listed or not),
- Consolidation and centralized supervision of post-trade market infrastructure located on EU territory,
- (Progressive) harmonization of EU "securities, corporate and insolvency laws".
- A combination of a top-down approach – with a single rulebook regarding listing, market abuse, products, etc, and a bottom-up approach – where each Member State works on developing its capital market.

Besides, having a fully-fledged Banking Union would not in itself create a single market for retail banking services[5]. This requires harmonization of legal, fiscal and consumer protection rules. Transnational banking groups would thus not fully benefit from economies of scale. Consequently, cross-border mergers would still be impeded by this fragmentation, and also by the Basel prudential requirements that increase capital requirements according to the size of the balance sheet. Indeed, Global Systemically Important Banks (GSIBs) are allocated by the Financial Stability Board into five "buckets" of ascending levels of systemic importance, and of accordingly ascending levels of additional capital requirements[6].

Finally, it has to be kept in mind that a major challenge in the Banking Union is to achieve the goals of an unrestricted single market while simultaneously allowing for competitive national subsystems. Steps towards further integration must have the entirety of the EU's diversified banking sector in mind. Measuring the proper functioning of the Banking Union should not solely focus on the existence of so-called "European champions" in the banking sector. This is not the silver bullet to create an even more stable and better functioning banking industry for Europe, its customers and the real economy.

2. Loopholes in the design of the Banking Union make it fragmented and suboptimal

Significant progress has been made on the Banking Union since the creation of the SSM and the SRM in 2014. The European banking sector has shown remarkable resilience amid the Covid-19 crisis, the war in Ukraine and the banking turmoil of Spring 2023. Yet, loopholes exist and make the Banking Union fragmented and suboptimal. The first section explains the issue persisting around the resolution for some domestic Less Significant Institutions (LSIs). The second section explores other key issues such as economic divergence, the home-host dilemma, the sovereign-bank nexus and ring-fencing practices that hinder progress on the Banking Union. The third section shows that the existing fragmentation undermines the profitability and competitiveness of the EU banking sector, and that as a result, EU banks lag behind international peers.

2.1 The SSM have enhanced the resilience of the EU banking system and the EU framework regarding bank resolution has progressed even if there remain issues for the resolution of some domestic Less Significant Institutions (LSIs)

The conception of the Banking Union relied on three pillars: the first one is supervision, the second one is resolution, and the third one – which is still a matter of discussion among Member States – is the creation of the European Deposit Insurance Scheme (EDIS).

The first pillar of the Banking Union is the Single Supervisory Mechanism (SSM), a new system of banking supervision comprising the ECB and the national authorities, directly supervising the 115 most significant banks of the Euro area (holding almost 82% of European assets). The enhanced regulatory and supervisory reforms implemented in the last 10 years have proved effective: the European banking sector has shown remarkable resilience during the banking turmoil of the Spring 2023.

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM) as well, which objective is to protect financial stability and the taxpayer by planning for and managing bank failures. This pillar needs improvements as national authorities continue to distrust the European framework, especially regarding Crisis Management and Deposit Insurance (CMDI).

4. Long-term saving products improve the financing of pension regimes (*e.g.* 401K in the US), improve the competitiveness of market activities in Europe and favor the development of EU asset managers.
5. See 2.1.
6. For instance, a GSIB allocated in the first bucket face an additional CET1 capital requirement of 1% of its total Risk-Weighted Assets (RWA). For the second bucket the additional CET1 capital requirement equals 1.5% of total RWA, for the third bucket the buffer equals 2% of total RWA, for the fourth bucket 2.5% of total RWA, and the fifth bucket would trigger a 3.5% buffer and remains for now only "dissuasive". Source: "The impact of the identification of GSIBs on their business model", ACPR, Banque de France, 15 March 2018.

European rules on resolution have often been divisive because there have been in the past discrepancies about the definition of Public Interest (PI) between the SRB and national resolution authorities. Yet, the EU framework has been seriously reinforced over the last decade, in particular for large banks: according to the SRB[7], 97 out of 113 banking groups under the SRB's remit are prepared for resolution and have built up their capabilities to comply with the SRB's Expectations for Banks (EfB) and the steady state MREL[8] target[9]. Additionally, the Single Resolution Fund (SRF) has reached 1% of covered deposits, marking the end of the SRF build-up phase.

The ESM has set aside €68 billion as an additional guarantee. This backstop to the SRF can only be used if the new treaty signed in 2021 enters into force, and that cannot happen unless all Euro area members ratify it. 19 countries ratified it. However, the Italian Parliament voted against. This new treaty could be presented again to the Italian parliament after six months.

One could hope that the progress achieved on the EU bank resolution framework would at least partly dispel the concerns of host jurisdictions and encourage them to lift some ring-fencing practices[10], especially regarding liquidity management in cross-border banking groups. Such a decision could send a positive signal to authorities and banks to resume making progress on the Banking Union. However, this is not the case at this stage (*see 2.2*).

On 18 April 2023, the European Commission published its proposal concerning the review of the BRDD, SRMR, DGSD and daisy Chains Directive – the Crisis Management and Deposit Insurance Proposal (CMDI). The EU Commission proposed in particular a new public interest assessment criterion that would increase the number of banks be put in resolution in case of their failure. Of the circa 2 000 Less Significant Institutions (LSIs) in the Banking Union, 68 were earmarked for resolution at the end of 2022. Out of these 68 banks, 25 still had a shortfall with respect to the final MREL target at the end of 2022.

The CMDI proposal is likely to bring additional banks into the scope of resolution, with the objective of strengthening financial stability and avoiding value depletion (where a transfer strategy is less costly than a liquidation). It changes the criteria to determine which bank goes in resolution (*i.e.* the so-called public interest assessment) but the decision on this matter remains a discretion of the relevant resolution authorities.

This expansion of the scope will impact banks that are likely to present, even when MREL compliant, the characteristics described above. This is why CMDI also aims at enhancing the funding options for financing these banks' market exits in resolution. The DGS Bridge would absorb losses the bank in lieu of deposits after MREL has been depleted up to the level of the 8% TOLF.

CMDI, in fact, proposes to make more practicable the possibility of using Deposit Guarantee Schemes (DGS) in resolution. In order to achieve its objectives, CMDI removes the DGS super priority, introduces a single-tier depositor preference and some harmonization of the Least Cost Test (LCT). In other words, CMDI proposes to modify the creditor hierarchy position of the DGS by putting it to the same level of uncovered depositors. This amendment, necessary to increase funding in resolution, was met by a strong opposition from the industry.

A European Deposits Insurance Scheme (EDIS) is considered the third pillar of the Banking Union. In November 2015, the EU Commission submitted a proposal for EDIS. No political agreement was reached ever since. Support within the industry has also been limited. With EDIS, about 2.200 smaller and regional banks organized in networks would lose their Institutional Protection Schemes (IPS) as they were not taken into consideration by the EDIS proposal. Large banking groups see costs of setting up EDIS outweighing its benefits.

2.2 The Banking Union faces a number of issues

Ten years after its creation, the Banking Union has not been completed as several key issues persist.

The EU banking sector is hampered by the heterogeneous economic situations of Member States which fosters distrust among national authorities and the SSM and the SRB.

The intensity of fiscal and economic divergences between EU countries as well as some Member States' fear that they will have limited influence over European decisions makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself" and creates a climate of mistrust between Member States. Additionally, these economic divergences give EU policy makers a hard time agreeing on a European safe asset as well on mutualized European Deposit Insurance Scheme (EDIS) and thus complete the Banking Union.

The heterogeneous economic situations are particularly displayed by the differences in public debt levels and

7. "SRB Bi-annual reporting note to the Eurogroup", Single Resolution Board, November 2023.
8. Minimum requirement for own funds and eligible liabilities (MREL) is one of the key tools in resolvability, ensuring that banks maintain a minimum amount of equity and debt to support an effective resolution.
9. Therefore, as of December 2023, the 16 remaining groups under the remit of the SRB would go into liquidation.
10. See 2.2.

current account balances from one Member States to another. For instance, over the past years, Germany has had a government debt fluctuating around 60% of its GDP while France has had a debt fluctuating between 110 and 115% of its GDP, and Italy's government debt has exceeded 140% of its GDP. Similarly, in 2022, one can observe important current account imbalances between Member States: while Germany's current account balance stood at 4.2% of its GDP, France and Italy displayed current account deficits of respectively -2.1% and -1.3% of their GDP[11].

As long as Member States follow this diverging trend, no significant progress towards the completion of the Banking Union, the CMU and the EMU will be achieved as Member States do not collaborate because they do not trust one another, and continued diverging trends in economic development mean there is not sufficient convergence within the EU, which is a prerequisite for a deeper Banking Union.

In his interview for the *Eurofi Magazine* (February 2024), A. Weber explains that "core countries with strong economic fundamentals fear that Banking Union could lead to sharing the financial burdens of less stable economies without adequate safeguards. Conversely, countries with higher public debt are more inclined towards mechanisms that facilitate risk sharing, hoping for potential fiscal relief or stability benefits. In contrast, countries with healthier fiscal positions prioritise risk reduction over risk sharing, fearing that integration could expose them to the fiscal irresponsibilities of others. More concretely, proposals that imply mutualising debt or risks (*e.g.*, through a common deposit insurance scheme as part of the Banking Union) face resistance from countries wary of underwriting the risks of others without stringent controls or are simply held hostage to negotiate a broader set of European agreements. This has been a stumbling block for any political agreement to pursue deeper integration in banking and capital markets".

The sovereign-bank nexus persists because of endlessly too high fiscal deficits in certain Member States.

Even though EU banks have now higher capital and liquidity ratios than they did in 2012 and that the EU banking sector proved resilient[12] during the banking turmoil of the Spring 2023, the Banking Union did not achieve its objective to break the sovereign-bank nexus, which is a threat to financial stability.

The persistence of the sovereign-bank loop is not the result of a dysfunction of the SSM or the SRB, but the consequence of fiscal slippage in some countries that have been exacerbated by the Covid-19 crisis (*i.e.* the budgetary excesses are encouraging banks to contribute to finance these deficits).

Indeed, according to EBA statistics[13], the domestic sovereign exposure of EU/EEA banks in December 2022 stood at 5.7% relative to their total assets, and at 101% compared to their capital, which means that the risk concentrated on domestic sovereign is still looming despite the downward trend. These figures are 9.9% and 160% for Italy, and 18.2% and 239.7% for Poland. Roughly 50% of banks' total sovereign exposures is to their home sovereign[14].

In November 2023, S&P Global Ratings wrote that Eurozone countries have not broken the link between public finances and banks and that investors could refocus on that vulnerability in 2024. "In light of weak economic growth, potential differences in the speed and magnitude of monetary and fiscal policies could bring the sovereign-bank nexus back under market scrutiny," S&P analysts explained. This doom loop dominated the EU sovereign debt crisis in 2010-2012; with increasing supply of government bonds and existing incentives to hold sovereign debt securities, banks may be tempted to increase their exposure to their sovereign but should have in mind the risks incurred. The sovereign doom loop could even increase with quantitative tightening, especially in highly indebted countries.

The EU banking sector is fragmented along national lines.

Ring-fencing occurs when host authorities take regulatory and supervisory action in order to secure bank financial resources within their own jurisdictions. There are no host supervisors anymore in the Banking Union, but the distinction between home and host authorities and the "national bias" still exist for banks operating across borders in the Banking Union under the remit of the SSM.

Indeed, national supervisors still fear that capital and liquidity could be trapped in other individual Member States or inadequately allocated from their own viewpoint if a pan-European banking group fails. This perception is particularly acute in countries that are strongly dependent on banks part of groups headquartered in other Member States for the financing of their economies. Furthermore, banks cannot create truly pan-Eurozone business because they must deal with a patchwork of national authorities' different views on macroprudential rules and conduct.

Ring-fencing policies are applied to capital, liquidities and MREL liabilities.

The obstacles to the integrated management of bank capital and liquidity within cross-border groups operating in the Banking Union remain persistent and fragment banking markets. While recognized in 2013 by the fourth Capital Requirements Directive (CRD4), capital and liquidity waivers remain at the discretion of the national supervisors, which are most often

11. See Macroeconomic Scoreboard, Eurofi, February 2024.
12. The Euro area banking sector's resilience to adverse shocks was also confirmed by the results of the European Banking Authority's 2023 EU-wide stress test.
13. Data from the EBA's Risk Dashboard.
14. See "Banking Fragmentation Issues in the EU", Eurofi Regulatory Update, September 2023.

reluctant to use them. In practice, all capital and liquidity ratios are applied at both solo and (sub-) consolidated levels, notwithstanding the possibility of waivers allowed by the legislation.

Calculations by the ECB Banking Supervision show that, in the absence of cross-border liquidity waivers – as it is currently the case – the combination of the European and national provisions prevents around EUR 250 bn of High-Quality Liquid Assets from moving freely within the Banking Union[15].

Excessive flexibility in the EU macroprudential framework also encourages ring-fencing measures. The legal framework for macroprudential tools grant flexibility to national designated authorities. The ECB can only intervene in the case of EU harmonized measures but many national macroprudential power are explicitly or *de facto* left at national level. Macroprudential decisions such as the level of certain capital buffers are still decided by national authorities, with scattered mandates for micro- and macroprudential authorities. There is currently no authority that is responsible for reviewing the aggregate capital requirements for a bank against its actual risk profile, which can lead to excessive capital requirements for even banks with low-risk balance sheets.

Moreover, several host authorities tend to submit any dividend distribution to their approval.
Several Member States tend to submit dividend distribution from subsidiaries to parent entities within cross-border banking groups to their approval, even if these distributions are organized at group level and thus should be supervised by the group supervisor in line with the different macroprudential measures taken, as well as with views to make the group more resilient and agile at the consolidated level.

Eventually, subsidiaries of European transnational groups can be required to have increased Pillar 2 Requirements (P2R). P2R is a legally binding bank-specific capital requirement which applies in addition to the minimum capital requirement (known as Pillar 1) where the latter underestimates or does not cover certain risks. The numerous instances where different P2R are applied by host supervisors to the same European banking group also illustrate the fragmentation of the EU Banking Union and the lack of harmonization within it. Indeed, even if the SSM is officially in charge of determining the level of P2R, including management buffers and Pillar 2 Guidance for subsidiaries, host countries can – most of the time successfully – submit their proposals to the SSM to increase such levels in order to protect their economy.

Root causes of ring-fencing practices have been identified but continue to exist.
First, ring-fencing is deeply rooted in the general lack of trust that is mainly due to economic and fiscal divergences between the largest Member States described above which prevents the creation of a EU safe asset that would enhance the diversification of risks.

The second root cause of ring-fencing measures is the bad memories of the EU sovereign debt crisis (2011-2012) in certain Member States such as Luxemburg or Belgium where some foreign banks have taken over national leading banks.

Eventually, host authorities are concerned with ensuring the financing of their national economic activities, and for some of them especially their public deficits. To do so, they ring-fence to keep the capital in the subsidiaries.

The market for retail banking services progresses too slowly: the lack of uniform standards, products and protection rules at the EU level is a barrier to an integrated European banking market which discourages cross-border banking.
Despite the EU Single Rulebook and the ECB's clarification of the supervisory approach to consolidation, a number of traditional factors such as legal systems, languages and custom remain and fragment banking markets. Additionally, the EU Commission explains that "differences in taxation, borrower protection, or anti money laundering provisions at Member State level result in bank-specific entry and adjustment costs that discourages cross-border banking". For example, there is no single EU-wide loan registry as it is the case in the US.

Moreover, there is a significant diversity in terms of banking products leading to the fragmentation of the EU banking landscape. For instance, banks in countries like Spain, Italy and Germany offer variable interest rates and are therefore directly affected by the ECB's rising interest rates whereas French banks mostly offer fixed interest rates.

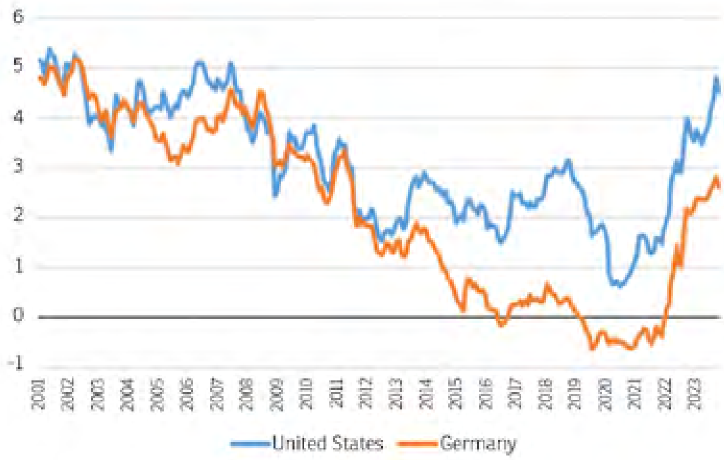
Such differences prevent banks from sharing processes and systems across European countries. Large banks consequently miss scale advantage when moving into new European markets and this undermines the potential for Europeanisation.

The Banking Union is hampered by the lack of cooperation among Member States.
Overall, progress on the Banking Union is hampered by the lack of cooperation. One example of that is the outcome of the proposals of the Eurogroup of December 2021 in order to complete the Banking Union. The Eurogroup proposed 4 areas to explore:

- To strengthen the framework for the management of failing banks in the EU,

15. "How can we make the most of an incomplete Banking Union?", Speech by A. Enria at the Eurofi Financial Forum, Ljubljana, 9 September 2021.

CHART 1.
10-year sovereign bond yields (%) in the United States and Germany



Source: OECD
Note: Note: the German government bond yield is considered as a benchmark for a EU safe asset and thus can be compared to the US government bond yield

- To create a more robust common protection scheme for depositors,
- To facilitate a more integrated single banking market for banking service,
- To encourage greater diversification of banks' sovereign bond holding in the EU

After 18 months of discussions, the Eurogroup decided in June 2022 to only focus on strengthening the Crisis Management and Deposit Insurance (CMDI) framework – which is not a central issue as mentioned above. In the meantime, no further concrete steps are contemplated in order to improve the single banking market or to tackle the sovereign-bank nexus.

Banking integration in Europe remains limited and the EU lacks private risk sharing mechanisms.
Private risk sharing mechanisms work through the credit channel (cross-border lending and borrowing) and the capital market channel (diversified private investment portfolios across Euro area countries). The more risk is shared through banks and markets, the fewer fiscal mechanisms are needed on the public side to address failures. Banking integration through private risk sharing mechanisms is essential to strengthen the EMU but the EU currently lacks such mechanisms. As A. Enria already stated in 2018[16], since 2007 in the Euro area, the credit channel has acted more as a shock amplifier than a shock absorber.

Cross-border assets held by banks in the Euro area have hardly changed since the launch of the Banking Union project. Furthermore, the cross-border integration of the sector has progressed at a snail's pace in recent years, including after the establishment of the single European banking supervision in 2014. Indeed, the share of cross-border loans to households and cross-border deposits from households in the Euro area remain negligible, a little above 1%.

2.3 Fragmentation undermines the profitability and competitiveness of the EU banking sector and as a result, EU banks lag behind international competitors

Fragmentation leads the European banking sector to struggle with excess capacity as cross-border Mergers and Acquisitions (M&A) activities among banks in Europe have drastically diminished since 2000.

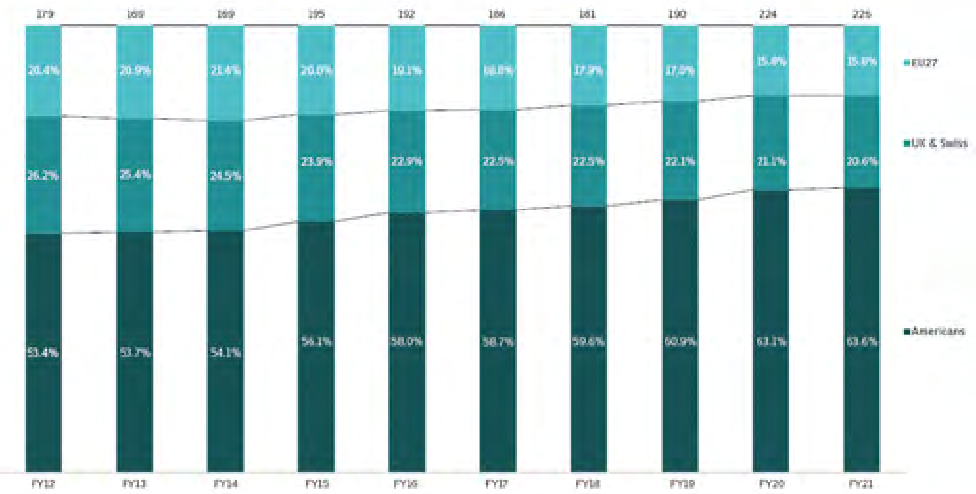
As a result, the EU banking sector is overcrowded, which puts pressure on banks' margins. Excess capacity also goes side by side with cost inefficiencies, which are two of the factors behind the structurally low profitability of EU banks. This is a real issue insofar as about 70% of the economic activity in the EU is funded through bank loans: the profitability of banks in the EU is all the more important as it being persistently weak can pose a risk to financial stability and to the EU strategic autonomy. Additionally, the ECB financial stability review of November 2023 highlights that bank stocks' low valuations – which is driven by political and regulatory uncertainty on top of economic expectations – may also pose a risk to financial stability.

In contrast, the profitability of American banks is fostered by several elements. First, growth in the US is stronger than in the EU: Since 1995, real US gross domestic product has increased more than 90 per cent, against the Euro area's more than 50 per cent. Interest rates are also structurally higher in the US than in the EU as evidenced by Chart 1.

Lasting low interest rates, as can be seen on Chart 1, have had negative consequences on EU banks profitability until 2022: it compressed net interest margins – which penalized them *vis-à-vis* their American counterparts. Indeed, net interest income represented 50% of EU banks' net operating income, and Profit and Loss (P&L) were made of more than 50% of credit and loan related activities.

16. A. Enria, Fragmentation in banking markets: crisis legacy and the challenge of Brexit, EBA, 17 September 2018.

CHART 2.
The market share evolution of EU banks in the global CIB market vs US banks (%)



Source: EBF

Furthermore, US banks benefit from a consolidated single market for banking services, which means that there is less competition than in Europe and American banks thus have a higher pricing power, which increase their revenue. Unlike the EU which has 27 Member States, the US is a single country, with a deep and liquid market for Treasury bonds, a consolidated post-trade infrastructure (DTCC) and one set of law regarding securities, corporate and insolvency. Additionally, the US has a genuine market for securitization with Government-Supported Enterprises (GSEs) such as Freddie Mac and Fanny Mae, and benefits from a strong equity financing ecosystem, including long-term saving products (*e.g.* 401K). Eventually, US retail savers are usually more prone to taking risks than European savers.

The overall profitability of EU banks – except during the Covid-19 pandemic – has improved but remains behind that of US peers.

At the beginning of 2008, the market capitalization of the top Eurozone bank was very similar to that of the top American bank. At the beginning of this year, JPMorgan Chase represented more than the first 10 Eurozone banks combined. The profitability of the European banking sector has eroded to be much lower than the other international players. Since 2008, EU banks have been weakened by poor growth, lasting negative interest rates, market fragmentation and lack of scale.

Chart 2 shows that European banks are losing ground to competitors, especially US banks that have a market share four times higher than EU banks. EU banks also have a CIB market share inferior to that of UK and Swiss banks.

3. Ways forward have been identified but are hampered by the prevalence of national interests over European interests

During the Eurofi Financial Forum of September 2023, officials and industrial representatives have emphasized the need for a mindset shift regarding the completion of the Banking Union and the integration of banking markets. Several ways forward have been identified, but their implementation requires significant will and effort. The first section outlines the main advantages and drawbacks of branchification as well as the reason why banks are reluctant to branchify retail activities. The second section explains that credible support provided by parent companies to Euro area subsidiaries based on European law and European authorities is another way forward to solve the home-host dilemma.

3.1 Branchification offers real benefits for wholesale banking, but branchifying retail activities is impeded by Member States

Branchification is the process of merging all existing subsidiaries into the parent company and only operating through the branches of a single, unified legal entity.

Benefits from branchification include "clearer governance and accountabilities, simpler and more effective balance sheet and liquidity management, avoidance of many duplicated requirements on subsidiaries (capital, liquidity, MREL...), ability to cater for large financing needs (scale benefits from a large balance sheet), one prudential supervisor, improved resolvability, and reduced reporting burden", explains J. Vesala[17], Head of Group Credit at Nordea.

17. J. Vesala, "Why there is little cross-border branching in the EU", Views, the Eurofi Magazine, September 2023.

Many obstacles remain and prevent banks from undergoing this transformation.
Branchification is very difficult to implement in banks that offer retail services as host jurisdictions are often opposed to such a legal structure. It is extremely burdensome and complicated for banks to do business in a country on a daily basis against the directives of the country's government, so it is easier for banks to keep their subsidiaries and avoid possible retaliation. Furthermore, even with a branch structure, national conduct rules need to be followed, and complex and varying macroprudential rules create unnecessary uncertainty that discourages banks from branchifying.

Additionally, technical obstacles to branchification exist and include legal hurdles and a pressure from host jurisdictions. Though Nordea chose this structure, J. Vesala acknowledges that "the process of branchification remains complex and cumbersome, even in the Nordic region. The challenges include transition uncertainties and the operational burden taking the focus away from regular banking business". For instance, banks aiming to convert a subsidiary into a branch may face problems for the treatment of the contributions to the local Deposit Guarantee Schemes (DGSs). There is no, or at best very limited "portability" of contributions between DGSs. This may represent a technical roadblock to convert a subsidiary in a branch but it is a technical issue that could be addressed.

3.2 Credible support provided by parent companies to Euro area subsidiaries based on European law and enforced by European authorities is another way forward to solve the home-host dilemma

Authorities in the host Member States may be concerned that, in the event of a crisis, the parent entity might refuse to support local subsidiaries. To address these concerns, European transnational banking groups that wish to operate in an integrated way could decide to commit to providing credible guarantees to each subsidiary located in the Euro area in case of difficulty and before a possible resolution situation ("the outright group support").

This "outright group support" would consist of mobilizing the own funds of the Group to support any difficulties of a subsidiary located in the Euro area. Since the level of own funds and the creation of MRELs have considerably increased the solvency of EU banking groups, they should be able to face up to any difficulty of their subsidiary located in the Euro area.
This group support should be based on EU law and enforced by EU authorities. It could be enshrined in groups' recovery plans and approved by the supervisory authority – the ECB – which would be neutral, pursuing neither a home nor a host agenda.

This would also ensure that the parent company has the necessary own funds to face the possible needs of their subsidiaries. This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level.

The SSM recognized that such a solution already proposed in a 2018 Eurofi paper, would, at least foster a more positive attitude from national authorities, creating the conditions for legislative change to happen sooner. Yet, due to the lack of confidence among Member States, it is not possible to implement it yet.

4. What to do?

One must acknowledge that a complete Banking Union would accelerate the integration of the European banking market with no national ring-fencing. Additionally, it is precisely the current degree of fiscal and economic convergence that makes idiosyncratic shocks more likely – and, therefore, the need of a fully functioning Banking Union that could prevent such a destabilizing spiral.

For several years, the Banking Union has been characterized by the absence of solutions to solve the "home-host" dilemma and is currently in a deadlock. Paradoxically, all stakeholders seem content with the situation: some host countries benefit from the capital of large groups' subsidiaries to contribute to the funding of their public debt and of their national financial needs and favor their particular interests to the detriment of the European ones. Moreover, European G-SIBs are reluctant to grow too much in order not to cross the threshold that requires larger buckets and are satisfied with not having to pay additional financial contribution which would further hurt their profitability (*e.g.* for EDIS).

We are not living in an ideal European community: national interests prevail over European objectives and benefits. Indeed, the solutions submitted are not supported by European political leaders. Moreover, the reinforcement and the rise of extremism and anti-European nationalism exacerbate this tendency to refuse to advance in the European construction and leave European projects in a sort of paralysis.

This is not doomed to be eternally the case, but without strong awareness and a willingness to act together as a European community, nothing will change, and the EU will remain in the deadlock it has been in for years now. This passivity and inaction are accompanied by the return of nationalism which takes precedence over European common interests.

In such a context, there is a need to:

- Re-establish discipline in the public finances of Eurozone overindebted Member States (France, Italy, Belgium…). In the tense current global context, fiscally virtuous countries face a number of difficulties and will not in addition incur the risks of paying for the slippage.
- Once all Member States have made sustainable adjustments to be close to fiscal balance, progress towards the Banking Union and the CMU will be possible as soon as all stakeholders – Member States, banks and financial institutions, display determination to cooperate and as the Commission empowers itself to conduct projects.

Baron Louis, Minister of Finance in France said to his government around 1820:
- "Faites-moi de la bonne politique et je vous ferai de la bonne finance", which can be translated as "Make good policies, and I will bring you good finance".

We could say under his tutelage and inspiration:
"Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you a Banking Union".

In other words, it is not only the Union that makes the Force, but also the Force that makes the Union: only strong Member States – which have corrected their fiscal imbalances and are effectively converging economically among themselves – will make Europe stronger.